Debt sustainability analysis

This assessment has been prepared by the European institutions.

The economic and financial situation in Greece has strongly deteriorated following policy uncertainty, shortfall in government revenues, the authorities' decisions that made the bank holidays and the imposition of capital controls necessary, and the missed payments to the IMF and Bank of Greece.

Hence, the sustainability of Greece's public debt has significantly deteriorated compared to the DSA published in the April 2014 Compliance Report prepared by the Commission in liaison with the ECB. At the time, the debt-to-GDP ratio was projected to reach 125% in 2020 and 112% in 2022. During the second part of 2014 Greece's debt sustainability improved further due to lower interest rates and the replacement of part of external funding sources by internal sources through repo operations with general government entities. These factors together with full programme implementation by the Greek authorities would have reduced the debt-to-GDP ratio well below the 2012 targets of 124% in 2020 and significantly below 110% in 2022. Under these circumstances, debt was deemed sustainable.

Since end of last year, a very significant weakening of commitment to reforms and backtracking on previous reforms and an overall climate of uncertainty have led to a significant deterioration of economic growth and fiscal prospects and hence of debt sustainability. The parameters that led to the deterioration in debt sustainability are the following:

- A significant downward revision of growth estimates. Real GDP growth projections are currently at -2.3 in 2015, -1.3 in 2016, 2.7 in 2017 and 3.1 in 2018. Long-term growth is assumed at 1¾% in the baseline scenario.

- The expected primary surplus outcomes have been revised downwards. The fiscal programme, which had been on track until the third quarter of 2014, was de-railed in the last quarter of 2014. The weaker implementation of reforms in the second half of 2014, expectation of debt generous settlement schemes, and the turn of the economic cycle led to a primary balance rather than a primary surplus. Moreover, the political uncertainties and the severe policy slippages of the first half of 2015 have led to a strong deterioration of economic growth and hence to weaker primary balance outcomes in that period. Furthermore, the imposition of capital controls and the severe liquidity shortage in the Greek economy now require a further downward revision of the fiscal targets at least for 2015-2017. Based on these developments, the primary fiscal targets agreed with the authorities are -0.25% in 2015, 0.5% in 2016, 1.75% in 2017 and 3.5% from 2018 onwards.

- Privatisation receipts are likely to be lower than envisaged when the last review was completed. The strong deterioration in the banking sector outlook, heightened economic and political uncertainty, more challenging financing conditions for potential investors together with reduced prospects for the privatisation programme result in lower expected privatisation proceeds, though the government committed to proceed with privatisation projects. We could expect until 2022 EUR 13.9 bn in non-bank privatisation receipts would materialise in the baseline scenario.

- Potential financing needs for the banking sector have increased considerably. The capital situation of Greek banks is coming under increasing pressure due to worsening asset quality that is related to the significantly weaker macro-economic development, high political uncertainty, the delayed NPL resolution process and the significant adverse impact of capital controls on economic activity and payment culture. In view of this banks will face substantial capital needs. As they will likely have no market access in the near future, an adequate capital backstop as part of a next financial assistance programme is needed. The estimated size of the required capital backstop amounts to EUR 25 bn. Further work on the calibration and terms of such capital backstop is currently ongoing based on an asset quality review and stress test to be undertaken over the coming weeks by the ECB.
- The projections do not include the transfers to Greece equivalent to SMP and ANFA profits up to 2026 following the statements of the Eurogroup whereby the agreement related to these transfers expired with the EFSF programme.

Based on the developments above and the implementation of the programme, the debt-to-GDP ratio in the baseline scenario A is expected to increase to 201% in 2016 before going down to 175% in 2020, 160% in 2022 and 122% in 2030..

In the scenario B based on partial programme implementation, it is assumed that privatisation receipts total only EUR 3.7 bn between 2015-2022, growth is lower by 0.5 pp. per year compared to the baseline scenario and the primary fiscal targets are lower at: -1% of GDP in 2015, 0% in 2016, 1.5% in 2017, 2% in 2018 and 3.5% from 2019 onwards. Based on these assumptions the debt-to-GDP ratio would increase to 207% in 2016, before falling to 186% in 2020, 174% in 2022 and 143% in 2030.

Table 1. Greece: debt-to-GDP in the three scenarios

	2015	2016	2017	2018	2019	2020	2022	2030
Scenario A	196,3	200,9	198,6	190,7	182,3	174,5	159,7	122,2
Scenario B	198,8	206,8	205,2	199,5	192,4	185,9	173,7	143,3
Scenario C	195,4	198,9	195,2	186,1	176,0	166,1	148,2	106,7

Scenario C is based on better outcomes, growth is assumed to be 0.5 pp higher compared to the baseline and privatisation revenue would total EUR 24.6 bn over 2015-2022 as it would include revenue from the privatisation of banks of EUR 10 bn. In this case the debt-to-GDP ratio would increase to 199% in 2016 before falling to 166% in 2020, 148% in 2022 and 107% in 2030.

In all three scenarios examined the debt-to-GDP ratio in 2020 and 2022 would be substantially above the 2012 targets of “124% in 2020 and substantially below 110% in 2022”.

However, focusing exclusively on the debt-to-GDP level does not allow capturing the structure of debt and is not accounting entirely for the measures taken by the European financial support. This aspect can be better assessed by the gross financing needs of a country, which captures its payment structure over time. Lower gross financing needs reduce rollover and financial stability risks. Greece currently benefits from very low debt servicing in the period up to 2023 due to low interest rates, interest deferral and a long grace period on both GLF and EFSF loans. As in the case of the debt-to-GDP ratio it is also difficult to determine concrete thresholds for this alternative metric above which public debt should be considered as no longer being sustainable. Based on cross country evidence, an

IMF guidance note to staff suggests that gross financing needs-to-GDP would need to remain below the 15% to ensure debt sustainability.

Given the further strong deterioration that followed the imposition of capital controls and the grinding to a halt of the Greek economy, gross financing needs-to-GDP in the adverse scenario are estimated at an average of around 12% in the 2020-2030 period and exceed in the following decades on average the 15% threshold. These simulations clearly illustrate the temporary nature of the low current financing needs related to the favourable conditions associated with the official sector support.

The high debt to GDP and the gross financing needs resulting from this analysis point to serious concerns regarding the sustainability of Greece's public debt. The concerns shall be addressed through a far reaching and credible reform programme, very strong ownership of the Greek authorities for such a programme and, after full restoration of the loans agreements, debt-mitigating measures that would be granted based on appropriate conditionality, including proven commitments to reform from the Greek authorities. One measure could be for the Eurogroup to reinstate the transfers equivalent to the SMP and ANFA profits which would bring the debt ratio down by 5 pp. of GDP in 2030. In sum, an appropriate combination of extension of maturities and grace periods for principals and interests would allow to bring Greece debt back to a sustainable level in gross financing needs terms without the need for a nominal haircut as stated by the Euro Summit of 12 July.